

KEEP THE BLOOD FLOWING

CASHFLOW IS A COMPANY'S LIFEBLOOD. **JEREMY RAYMENT** REVIEWS WAYS TO MANAGE ITS FLUCTUATION

It is an ironic feature of recessions that a large number of businesses survive the darkest days of the downturn, but fail just as the economy turns and we see signs of recovery.

The reason that the vast majority of businesses fail is because of cashflow problems, not necessarily because they are unprofitable. When the economy emerges from recession and sales start to grow, both debtors and work in progress increase. This sucks up working capital, and if cashflow is not carefully managed, businesses can easily become over-extended. A business can be profitable, but if creditors cannot be paid it will soon cease trading.

Of course, banks have traditionally provided facilities to help businesses manage fluctuations in their cashflow, but this recession is different. It was caused by a banking crisis that itself was triggered by runaway debt. As a result, traditional bank lending is still relatively scarce, and so growing businesses may well have to look elsewhere for funding.

Equity finance may be attractive but it is expensive. Debt typically costs 7% to 10% a year of the amount borrowed, whereas equity may typically exceed 30% to 40% over the course of its investment. In addition, many business owners will not consider giving away control of their business – even a minority shareholding – to a third party.

However, London is one of the world's largest and most sophisticated financial centres, with access to many specialist finance houses, including asset finance.

Asset-based finance can provide a more acceptable solution. The two most common types relate to debtor financing, and are invoice discounting and factoring, but there are other creative ways of raising money on the back of an asset.

THE BIGGEST ASSET

In today's economy, a company's biggest asset is often its debtors' ledger. This is certainly true of service businesses, but even in traditional manufacturing businesses the low resale value of



plant and equipment often means that debtors still make up a large share of total assets.

With invoice discounting, you retain ownership of your debtors' ledger but raise finance on the strength of it. If your company is well managed and has good debt management processes, the debtors' ledger is a valuable asset, and banks will often lend between 70% and 90% of its book value.

Compared to a traditional overdraft facility, banks prefer facilities relating to debtors including invoice discounting because it not only provides a high degree of security (and hence low risk), but also the

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facility fluctuates to mirror the business cycle and is therefore a far more appropriate, and beneficial, facility for their customer.

However, the amount of money they will be prepared to lend will depend on the nature of the debt on the book. They like to see a broad spread of debtors, ideally based in the UK. An over-reliance on one or two large clients or debtors based in overseas jurisdictions will increase the risk and consequently reduce the amount that the bank is prepared to lend.

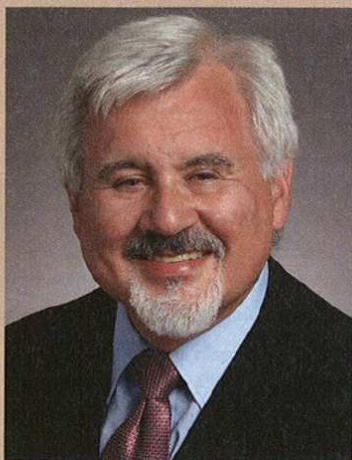
Factoring is a slightly different form of finance because the company sells the debtors' ledger to the factor. Invoices are issued as normal, but the factor collects the payments. At first glance this may seem like the ideal solution – you pass over the debt in exchange for a guaranteed amount of cash, and recovering the outstanding money is the bank's problem. But factoring is not right for all types of business.

The factor is primarily interested in recovering outstanding debt, and will pursue outstanding invoices vigorously. Many service-based companies rely heavily on fostering good long-term relations with their clients, and may be uncomfortable allowing such



a sensitive task as debt recovery to be handled by a third party. As a rule of thumb, factoring is better suited for high-volume transactional businesses with an impersonal product sale, where relationship goodwill is not a critical part of the sales and business model.

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CASE STUDY: RICHARD JOSEPH

North London sole practitioner Richard Joseph has been using fee funding, or spread payment facilities, for many years. 'We always used to run the practice on a bank overdraft to fund outstanding fee debts, but since we have used fee funding facilities, supplied by Orchard Funding Ltd [www.orchardfunding.co.uk], we have run on a positive cashflow.'

The use of spread payment facilities is an effective way of accelerating cash into your practice with no cost to the practice. Professional practices have benefited from this type of service over the past couple of years. For example, a firm can offer its clients a payment solution whereby they pay on a monthly basis for a small service charge (over a six, 10 or 12 month period). The firm receives payment for the services in full from the provider of the spread payment facility, and doesn't have the hassle of chasing for late payments.

'We thought the clients might be resistant to this sort of payment system, but in fact they love it, and merrily sign up year after year to renew their facility,' says Joseph. 'It helps relationships with clients, as they don't feel inhibited to telephone for advice, which they often did when they knew they owed you money. A big plus factor is that no credit check is carried out on them personally.'

The process is simple and the benefits are obvious, in fact everyone is happy – the pressure has been taken off the client to pay in full, the firm receives an injection of cash and the provider of the spread payment facility profits from the service charge. Perhaps the only pitfall is the fact that this finance solution is now becoming less available to SMEs, so it may be necessary to shop around to find a company that will do business with them.

Lesley Bolton

An over-reliance on one or two large clients or debtors based in overseas jurisdictions will increase the risk

EFFECTIVE RISK REMOVAL

A criticism of invoice discounting and factoring is that it can be a relatively expensive form of finance. But that is to oversimplify the matter. It is more expensive than some other types of debt (eg loans, asset leasing etc), but because the supply of finance is closely correlated with the business cycle, including seasonality and growth (and the requisite demands on cashflow that such a cycle has), it is a very effective way of removing risk from the business.

Therefore, what you are effectively doing is sacrificing some profitability for lower risk – and in certain business conditions that can be a very useful trade-off.

To explain further, when the economy is pulling out of recession, businesses may well experience a period of high growth, which will create high demands on cashflow through an increase in debtors, creditors and work in progress. Assuming that these all rise in proportion, a rapidly growing business will require a large increase in working capital. A business that fails to secure such working capital will be starved of its life blood: cashflow.

The appeal of invoice discounting and factoring is that, because the financing facility is based on the size of the debtors' ledger, it grows in step with the demand for working capital, thus taking risk out of the business.

However, it should be said that, although asset finance reduces risk, it does not mean that there is no

longer any need to manage debtors or have good management systems in place. Banks dislike risk, and the availability of finance remains dependent on maintaining good processes and controls.

Factoring and invoice discounting are the most popular forms of asset-based finance, primarily because the asset on which lending decisions are made – ie, the debtors' ledger – has a high, clearly quantifiable realisable value.

MARKET VALUE

However, wherever there is an asset with some market value, it will be possible to secure finance from it. Whereas debtor financing may secure finance between 70% and 90% of asset value, other assets will likely secure far less of their book value. Stock and work in progress in particular are usually very poor means of securing finance, primarily because the assets may prove difficult to realise, as there is a limited market for them.

That said, if improving cashflow is important, assets such as company cars can be leased to employees. Another possible option for generating cash is to sell fixed assets such as buildings on a sale-and-lease-back basis.

To summarise, when considering finance it is important to look at the bigger picture. The cost of finance is important because it affects profitability, but in all businesses one rule holds true: turnover is vanity, profit is sanity ... but cash will always be king.

MANAGING AND RAISING FINANCE

Guidance for SMEs on a range of finance issues is available at www.icaew.com/enterprise

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AN OPPORTUNITY TO MEET POTENTIAL TRAINEES WEDNESDAY 24 NOVEMBER 2010

There will always be competition for the best accountancy trainee. To help you in this process the Croydon & District Society is once again arranging for local firms to meet high-calibre students face to face.

This is your opportunity to gain direct access to a pool of talent before they have been signed up by other accountancy firms – and attendance at this event is free.

The students who attend will be predominantly third-year accounting and finance students carrying up to eight ICAEW examination credits, but there may be students from other business disciplines.

Following presentations for firms attending and for the trainees, there will be speed meetings between firms and Kingston Business School students. We would expect each firm to meet 15-20 students on an individual basis for three minutes each student. Each student will present you with a photograph and a CV to enable you to remember those students you would like to invite for more formal interviews.

This is a great opportunity to help you meet your recruitment needs.

For more information, or to book your place, please contact Jacquie Fairclough at jacquie.fairclough@icaew.com